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TAGS: [EFIN](#) [VE](#)
SUBJECT: STRUCTURED NOTES REDUX: NEW RESOLUTION ROILS
VENEZUELAN BANKING SECTOR

REF: A. CARACAS 190 AND PREVIOUS
[1](#)B. 2007 CARACAS 2130
[1](#)C. CARACAS 844
[1](#)D. CARACAS 376

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) a
nd (d).

[1](#)1. (C) Summary: A Ministry of Finance (MoF) resolution ordering Venezuelan banks to divest themselves of "structured notes" issued by foreign investment banks has roiled the local banking sector. Local banks hold an estimated USD 5 billion worth of these instruments, which are bolivar-denominated notes generally backed by dollar-denominated BRV sovereign debt deposited by the local banks with the foreign banks. Local banks bought these notes as an inexpensive means of getting around longstanding limits on foreign currency holdings. If local banks are forced on short notice to sell the underlying BRV sovereign debt and convert the dollar proceeds back into bolivars, the price of BRV debt and the parallel rate would both plummet, and some smaller banks might become insolvent. Given the negative impact on the price of BRV debt, our contacts believe the BRV will not force this outcome. Instead, banks are negotiating with the BRV to extend the time-frame for implementation of the resolution. Failing that, they will likely seek other (inevitably more expensive) ways of getting around the foreign currency limits. The MoF resolution took the banking sector by surprise, and contacts are still debating the BRV's underlying motives in issuing it. End summary.

Resolutions Target (Another Kind of) Structured Notes

[1](#)2. (U) On May 19, the MoF issued a resolution ordering local banks (and other financial institutions) to divest themselves of bolivar-denominated structured notes emitted by foreign banks (or other financial institutions) within 90 days and prohibiting them from buying or accepting these notes as payment. Then, on June 18, three days after Ali Rodriguez Araque's appointment as the new Finance Minister, the MoF issued a second resolution prohibiting the sale of local banks subject to the first resolution (i.e., banks that owned structured notes) and the sale of shares by shareholders owning more than five percent of one such bank; mandating that external auditors reveal in their June 30 reports the "quantitative impact" of divesting these notes on the banks

in question; threatening sanctions on banks that do not comply with the two resolutions; and noting that banks that do not comply with a related mandate from SUDEBAN, the BRV's banking regulator, to present a divestment plan for approval must nonetheless make provisions for any losses and ensure compliance with sections of the General Banking Law that deal with recapitalization after losses of a certain magnitude.

¶3. (SBU) These structured notes are completely distinct from the packages of dollar-denominated sovereign debt of Argentina, Ecuador, and Venezuela (and perhaps other countries) sold periodically by the BRV on the local market for bolivars (Bs) and also referred to as structured notes (ref A). The structured notes identified in the May and June resolutions are the opposite in the sense that they are privately issued bolivar-denominated instruments which some local banks acquired from foreign banks in return for depositing dollar-denominated instruments with those foreign banks. Our contacts believe that the vast majority of the dollar-denominated instruments deposited by local banks with the foreign banks are BRV bonds, i.e. Venezuelan sovereign external debt. (Note: Some of these bonds, or the dollars used to purchase them, may have been obtained through the purchase of the other kind of structured notes mentioned above. End note.) Based on local banks' audited financial statements (available from the webpage of the Venezuelan Banking Association), local analysts believe roughly 12 Venezuelan banks possessed structured notes with a book value of approximately USD 5.5 billion (at the official exchange rate of 2.15 Bs/USD) as of December 31, 2007. Most banks booked the notes as "investments in securities maintained to maturity," suggesting banks' intention to hold the underlying assets as long-term investments and allowing them to use book value on their balance sheets.

¶4. (SBU) While none of our contacts has been able to describe the exact structure of these notes, we believe most of them are arrangements similar to certificates of deposit whereby the foreign bank promises the local bank a revenue stream in bolivars tied to the value of the underlying dollar-denominated asset but gives the local bank the option to forgo the bolivars and keep the dollars. According to our contacts, the notes are not liquid (though the underlying assets are); the local bank assumes all the risk related to changes in the value of the underlying assets (and the rate of conversion from dollars to bolivars, should the local bank want bolivars); the foreign bank charges a fee of roughly 0.5 percent of the assets' value to structure the notes; and there are unspecified fees built into the contract should the local bank seek to return the notes back to the foreign bank in return for the underlying asset before the notes mature. Per local banks' financial statements, foreign banks that issued these notes include well known players like HSBC, Lehman Brothers, Barclays Bank, and Deutsche Bank, and lesser known players like "Esmerald Partners".

¶5. (SBU) According to banking contacts, local banks began acquiring the notes in 2004 as a relatively inexpensive way of getting around a longstanding Central Bank (BCV) mandate limiting banks' net position in foreign currency as a percentage of capital. This mandate has been in effect for roughly 20 years, according to one contact, and was raised by the BCV in 2006 from 15 to 30 percent. This same contact explained that the mandate was introduced for political show (i.e., to allow the government to give the impression it was doing something about capital flight) and that the BCV's definition of "net position in foreign currency" purposefully gave banks many ways of getting around the requirement. In justifying its resolutions, the MoF explicitly noted that the notes "could constitute a mechanism for evading controls imposed by the state" and invoked the state's obligation to ensure a stable and transparent financial system. (Note: We have not been able to find a line showing each bank's net position in foreign currency as a percentage of capital in information published by SUDEBAN, but we presume each bank must submit this calculation to SUDEBAN and the BCV. End note.)

Potential Impacts: Diverging Views

¶16. (SBU) Local analysts have divergent views on the impact these resolutions will have on the financial sector. The worst-case scenario makes the rather large assumption that local banks acquired most of the underlying dollar-denominated assets at an exchange rate of, for example, 5 Bs/USD. (Note: Given Venezuela's currency controls, banks generally cannot acquire dollars at the official exchange rate. Instead, they must go to the parallel market or buy the other type of structured notes emitted by the BRV. End note.) If local banks were forced to return the structured notes back to the foreign banks (for a penalty, of course) and then (because of the 30 percent limit) sell the underlying dollar-denominated assets for the current parallel market rate of 3.4 Bs/USD, those banks would clearly register "important capital losses," as economist Jose Guerra put it in an interview with a local daily. There would be two other significant consequences to any large-scale sale of underlying assets, namely a sharp fall in the parallel rate and in the price of BRV sovereign external debt, as local banks flooded the international secondary market with dollar-denominated BRV sovereign debt (the underlying assets) and sought to convert the dollar proceeds into bolivars. (Note: There are also rumors that in isolated cases the structured notes were issued by shadow companies without underlying assets. To the extent these rumors are true, the resolutions should have the effect of uncovering this fraudulent inflation of assets. End note.)

¶17. (C) Three financial sector contacts - the chief economist of the Venezuelan Banking Association (strictly protect throughout), the chief economist of one of Venezuela's largest banks, and the president of a small bank - presented a more optimistic view in separate conversations with emboffs. Two of these contacts noted that even if banks were forced to sell the structured notes, there was no guarantee they would have to sell the underlying dollar-denominated assets; instead, they could find other ways of meeting the 30 percent requirement, for example through options and futures contracts. All contacts believed that even if the banks had to sell the underlying dollar-denominated assets, many of these sales would actually register a profit rather than a loss (at least at today's bond and parallel market prices). They acknowledged, however, that several smaller banks that chose to go long in dollars in the latter half of 2007 (when the parallel rate shot up to almost 7 Bs/USD) might face debilitating losses. Finally, they all expressed doubt that the BRV would force a large-scale sell-off of its own sovereign debt (i.e., the underlying assets) once it fully understood the impact such a sale would have on prices of its bonds and on the banking sector.

¶18. (C) We agree with our financial sector contacts, with the caveat that the ultimate impact will depend on future BRV decisions (which are hard to predict) and the specific financial situations of the banks involved (which are hard to know). The BRV certainly has a history of issuing tough resolutions that would hurt the banking sector and then backing off when it realizes the larger economic impacts that would result. A recent example is the tax on financial transactions, which the BRV announced October 3, 2007; modified significantly October 26 after banks pushed back; and abolished on June 11, 2008 (refs B and C). The BRV could blunt the impact of these resolutions by, for example, exempting BRV bonds from the calculation of "net position in foreign currency" or by granting banks extensions to the 90 day timeframe (as, per one of our contacts, SUDEBAN has started to do).

¶19. (C) Other evidence that supports the argument that the negative impact will not be systemic, but at most limited to several smaller and potentially one medium-sized bank, comes from the audited financial statements. As best we can make out, the two largest banks holding structured notes - Banesco

(Venezuela's largest bank by capital) and Banco Occidental de Descuento (BOD, Venezuela's fifth largest bank by capital, whose president is Victor Vargas) - acquired the vast majority of their notes before June 30, 2007 (i.e., before the parallel rate really shot up). As of December 31, 2007, they held notes with book values of Bs 1.5 billion (USD 700 million at the official exchange rate) and Bs 2.5 billion (USD 1.2 billion), respectively. One bank that may have greater difficulty should it be forced to give up its structured notes is Banco Federal, the sixth largest bank by capital. According to its December 31, 2007 statement, Banco Federal acquired structured notes valued at Bs 1.7 billion (USD 790 million) in October 2007 and "unit trust certificates" (which could have a similar structure) valued at Bs 1.5 billion (USD 700 million) in October and December 2007. For the sake of reference, Banco Federal's capital as of May 31, 2008 was Bs 870 million (USD 405 million), or 4.5 percent of the overall capital of the banking sector.

The Great Mystery: Por Que?

¶10. (C) Our contacts are mystified as to why the BRV issued these resolutions. They noted that the resolutions targeted a specific asset class that has existed, and has been known to the BRV, for almost four years; that the resolutions were poorly written and of dubious legality (specifically, several contacts questioned whether the BRV has the right to force banks to sell particular assets); that the resolutions, given the nature of the issue, should have been emitted by SUDEBAN rather than the MoF; and that the resolutions, if taken to their logical conclusion, would cause the price of BRV debt to plummet (thus, presumably, hurting the BRV). As one

contact pointed out, in a larger sense the resolutions undermine the economic model of ordered capital flight that the BRV itself has promoted, whereby the BRV issues external debt or sells the dollar-denominated structured notes to the private sector, including banks, payable in bolivars, as a way of draining liquidity (see ref D for a description of this practice and some of the problems associated with it). The BRV apparently still does not have a clear idea of the impact of the resolution. According to an economist with contacts in the MoF, Rodriguez, at the suggestion of Venezuelan IMF Executive Director Jose Rojas, requested that an IMF delegation visit Venezuela to advise the MoF on the potential problems associated with the structured notes and the resolutions. The economist said the delegation was due to arrive July 3. (Note: If true, it is enormously ironic that the BRV would make this request, given that President Chavez considers the IMF a tool of the "empire." End note.)

¶11. (C) The most widely-shared explanation for the resolutions is that someone (and no one knows who) convinced President Chavez that banks should be punished for "speculating" against the bolivar in the second half of 2007 and thus (the argument goes) bidding up the parallel rate, causing greater inflation, and even perhaps influencing the outcome of the December constitutional referendum. Yet this argument does not fully explain the timing of the resolution - five months after the referendum and when the parallel rate had fallen - unless, perhaps, the person who convinced Chavez stood to benefit somehow. Others have speculated that the resolution was crafted to offer the BRV a pretext to take over several banks without having to nationalize them. Others believe it specifically targets Banco Federal, whose president, Nelson Mezerhane, is also a significant shareholder of Globovision, an opposition cable station.

¶12. (C) Finally, there is great speculation that the prohibition on the sale of banks or significant amounts of shares in banks that own structured notes was in some way intended to stop the rumored potential sale of Banco de Venezuela (owned by the Spanish Grupo Santander) to BOD (perhaps to be paid in part with the assets underlying structured notes owned by BOD). If the BRV indeed had this goal, the resolution is a clumsy mechanism for achieving it,

as it does not appear to prohibit such a sale given that Banco de Venezuela does not own structured notes. (Note: A contact working with one of the banks in question would not confirm to emboffs whether a sale was in the works, but he left us with the distinct impression that talks had taken place in Madrid. End note.)

Comment

¶13. (C) The saga of the structured notes is murky, multi-layered, and not yet over. Although we do not think the BRV resolutions will have a large or systemic impact on the banking sector, the saga, as we understand it to date, provides a window into the often haphazard world of economic policymaking in the BRV. The resolutions were clearly issued without consulting the sector involved and almost certainly without a coherent analysis of their potential impact. With the first resolution issued as one Finance Minister was close to departing and the second issued shortly after the new minister was appointed, the timing suggests that the minister is not driving policy. We will continue to follow this saga as it plays out, endeavoring to fill in the gaps in our understanding and to provide updates on how the BRV proceeds with implementation. End comment.
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